Are You Prepared? MTC and States to Finally Begin Transfer Pricing Effort

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Learning Objectives

• Understand the general features of IRC § 482
• Comprehend the ways in which states adopt (or don’t adopt) IRC § 482
• Identify the various approaches to remedying IRC § 482 infractions, between both the federal government and state governments generally and the variations among the states.
• Understand the status of the MTC’s transfer pricing program
• Identify the risks associated with intercompany transactions and the ways to prophylactically reduce those risks and/or mitigate those risks under audit.
Agenda

• What is Transfer Pricing?
• Overview of IRC § 482 and State Conformity
• History of Multistate Tax Commission’s State Intercompany Transactions Advisory Service
• Recent and Ongoing Transfer Pricing Litigation in State Courts
• Uptick in Transfer Pricing Review During Audits
• What’s Next and How to Prepare
What is Transfer Pricing?

General Overview

• Pricing of transactions between related entities for goods, intangible assets, services, loans, etc.

• Designed to prevent tax avoidance among related entities by requiring pricing that places controlled transactions on par with transactions between unrelated entities
  • Transactions must (generally) be at arm’s length
  • Use “comparables” for arm’s length standard because identical transactions are often not available
  • Non-arm’s length intercompany transaction can impact the clear reflection of income in states where income is reported on a separate or partial combination basis

• A tax evasion or avoidance motive is generally not a prerequisite to make a § 482 adjustment
Polling Question No. 1

Has your company experienced a proposed federal audit adjustment based on IRC § 482?
A. Never;
B. Once;
C. More than once;
D. Occasionally;
E. It’s a regular part of the federal audit cycle.
Overview of IRC § 482 and State Conformity
Overview of IRC § 482

General Overview of IRC § 482

• Transfer pricing is generally governed by IRC § 482 and federal regulations
  • Adjustments permitted among related entities if necessary to prevent evasion of taxes or to clearly reflect the income of such businesses.

• Language of IRC § 482
  • In any case of two or more organizations, trades, or businesses...owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses...

• A classic IRC § 482 adjustment is to reallocate income between related transacting parties as would have been if the price charged for a good or service was market price

• However, whenever there is a positive IRC § 482 adjustment in one country or entity, there should also be a negative adjustment in the other (known as a “correlative adjustment”)

Overview of IRC § 482

General Overview of § 482

• There are a variety of transfer pricing methods you can use to support your pricing decisions, and that taxing authorities can use to challenge those decisions:
  • The Comparable Uncontrolled Price (“CUP”) Method;
  • The Resale Price Method;
  • The Cost Plus Method;
  • The Comparable Profits Method;
  • The Profit Split Methods; and
  • Unspecified Methods (such as a bona fide third party offer to buy or sell goods)

• The Regulations require that you use the best method, which is the one that you have the best data to support
State Use of IRC § 482 Authority

Most States Have Authority to Adjust Income and Deductions Arising from Intercompany Transactions

• Many states have statutes that adopt or are substantially similar to IRC § 482, but may assert a broader authority than traditional federal transfer pricing adjustments.

• Some states with no IRC § 482 equivalent assert their right to adjust intercompany pricing based on general federal conformity or general discretionary authority.

  • This conclusion was rejected in Comptroller of the Treasury v. Gannett Co, Inc., 741 A.2d 1130 (Md. 1999). The court concluded that because IRC § 482 appeared to confer discretionary authority to the IRS Commissioner, it should not be assumed the Maryland legislature intended to confer similar powers on its own tax agency. (The legislature subsequently adopted a more limited statute.)

• Nearly every state adopts some statutory regime to adjust prices of intercompany transactions

  • Notable states that do not: Delaware, New Mexico, and Pennsylvania
State Use of IRC § 482 Authority

State Transfer Pricing Adjustment Authority

• Some states directly cross reference IRC § 482 in their transfer pricing statutory provisions
  • *E.g.*, Alabama, Ala. Code § 40-2A-17
  • (a) In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Commissioner of the Alabama Department of Revenue may distribute, apportion, or allocate gross income, deductions, credits, or allowances, if the Commissioner determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of Alabama income taxes or to clearly reflect the income of any such organization, trade, or business.

[ . . . ]

• (f) The Commissioner . . . shall exercise such authority in a manner consistent with this act and, to the extent applicable, 26 U.S.C. Section 482 and the rulings and regulations issued thereunder.

State Use of IRC § 482 Authority

State Transfer Pricing Adjustment Authority

• Some states have a separate statute that is worded almost identically to IRC § 482, but the states’ interpretation of their authority under the statute may differ from federal law:
  • Significantly, state-equivalent IRC § 482 statutes were used as the statutory basis to require combined reporting in two 1980’s cases:
    • *Joslin Dry Goods v. Dolan*, 615 P.2d 16 (Colo. 1980);
    • *Pioneer Container Corp. v. Beshears*, 684 P.2d 396 (Kan. 1984);
    • But see, *Chesapeake Ind. v. Comptroller*, 475 A.2d 1224 (Md. 1984) (combined reporting not available as a remedy where Maryland statute required separate entity filing).
  • Since the *Chesapeake* decision, no state has asserted that its IRC § 482 authority, without more, gives authority for mandating combined reporting.
State Adoption of Sec. 482 Authority

State Transfer Pricing Adjustment Authority

• In some states, the “482” language serves as the basis for the state’s mandatory combined reporting regime:
  • E.g., Ariz. Rev. Stat. § 43-941:
    A. In any case of two or more persons, organizations, trades or businesses, whether or not organized in the United States and whether or not affiliated, owned or controlled directly or indirectly by the same interests, the department may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such taxpayers, if it determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such taxpayers.”

    B. For the purpose of enforcing this section, the department may require the filing of a combined report and such other information as it deems necessary unless the taxpayer has elected or is required to file a consolidated return pursuant to section 43-947.

    • See also Kan. Stat. Ann. § 79-32, 141
State Use of § 482 Authority

State Transfer Pricing Adjustment Authority

• Some states assert statutory language broader than IRC § 482 authority
  • *E.g.*, Virginia, Va. Code Ann. § 58.1-446
    • When any corporation liable to taxation . . . conducts the business of such corporation in such manner as either directly or indirectly to benefit the members or stockholders of the corporation . . . by either buying or selling its products or the goods or commodities in which it deals at more or less than a fair price which might be obtained therefor, or when such a corporation sells its products, goods or commodities to another corporation or acquires and disposes of the products, goods or commodities of another corporation in such manner as to create a loss or improper taxable income, and such other corporation . . . controls or is controlled by the corporation liable to taxation under this chapter, the Department may require such facts as it deems necessary for the proper computation provided by this chapter and may for the purpose determine the amount which shall be deemed to be the Virginia taxable income of the business of such corporation for the taxable year . . .
    • But could this provision be read to apply only to intercompany sales of tangible personal property?
State Use of § 482 Authority

Varied State Use of Transfer Pricing Authority

• Historically, few states have utilized their IRC § 482 type authority
  • States rely on formulary apportionment for determining where corporate income is earned
  • By contract, the US and virtually every other nation rely on transfer pricing for sourcing cross border income
  • States have limited experience with transfer pricing and few resourced trained to apply transfer pricing rules as compared with the IRS or foreign taxing authorities

• States also have utilized other solutions for policing related party transactions
  • *E.g.*, asserting nexus, combined reporting, statutory addback

• Rather than engaging in substantive pricing analysis, states are increasingly:
  • Attempting to disregard intercompany transactions
  • Disallowing 100% of tax outcome by arguing that transactions are per se distortive
  • Establishing “settlement” parameters for certain types of transactions
Polling Question No. 2

Has your company used transfer pricing reports to challenge:

A. State transfer pricing adjustments;
B. State add-back statutes;
C. Unitary determinations;
D. Economic substance claims/other
E. Never pulled it out of the drawer.

Council On State Taxation
The Role of Section 482 in State Tax Controversies

Is IRC § 482 Limited to Transfer Pricing Adjustments

• Many state tax controversies arise as a result of IRC § 351 non-recognition transfers of property between related parties.
  • Treasury Regulation 1-482.1(f)(iii):
    • Non-recognition provisions may not bar allocation -
      • (A)In general. If necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under section 482 with respect to transactions that otherwise qualify for non-recognition of gain or loss under applicable provisions of the Internal Revenue Code (such as section 351 or 1031).
    • Example in regulation relates to a parent’s contribution of depreciated stock to a subsidiary followed by the subsidiary’s disposition of the stock
State Emphasis on Transfer Pricing

Increased State Interest in Transfer Pricing Interest

• Although the laws just described are not new, state emphasis on transfer pricing has increased considerably in the past decade. Why?

• In part, due to the global attention accorded to the problem of cross-border income taxation and to the Organization for Economic Co-operation and Development’s (OECD) Base Erosion and Profit Shifting (BEPS) Project

• It is also attributable to the publicity surrounding the Multistate Tax Commission’s (MTC) Arm’s Length Adjustment Services (ALAS) Project (now called the State Intercompany Transaction Advisory Service – “SITAS”)

• In particular, many states with separate entity reporting have expressed interest in expanding their transfer pricing audit capabilities
Polling Question No. 3

Do you perceive that the states are becoming more aggressive in:

A. State or international transfer pricing adjustments;
B. Use of add-back statutes;
C. Alternative apportionment;
D. Economic substance claims/other;
E. The states’ auditors are pushovers.
The MTC’s Foray
Into Transfer Pricing
State Emphasis on Transfer Pricing

Origin of MTC Involvement in Transfer Pricing

- In December 2013, the MTC Executive Committee authorized the executive director to explore interest in, and if enough states expressed interest, begin the design of an Arms-Length Adjustment Services (ALAS) project
  - Participating states were Alabama, D.C., Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, and North Carolina
- Two components of ALAS project
  - Providing/developing economic expertise
  - Conducting transfer pricing audits
MTC Final Program Design

• MTC Executive Committee approved the Final Program Design in May 2015, although only five states formally committed:
  • Alabama, Iowa, New Jersey, North Carolina, and Pennsylvania

• In December 2015, the MTC created an ALAS Committee to continue to gather support for, and refine the design of its ALAS initiative.

• The ALAS Committee would initially focus on information sharing and training relating to transfer pricing.

• Potential exists for state revenue agencies to be supported by external economic consulting firms in the following areas:
  • Training
  • Audit selection
  • Economic analysis
  • Litigation support
  • Business purpose/economic substance evaluation
State Emphasis on Transfer Pricing

Rebranding and Relaunch

• In August 2016, the ALAS Committee re-branded itself as the State Intercompany Transactions Advisory Service (“SITAS”)

• SITAS also approved a draft Information Sharing Agreement, allowing participating states to discuss specific case studies and best practices during future training sessions.

• In October 2016, SITAS held its first formal training session

• Tax representatives from 9 states attended the training:
  • Alabama, Indiana, Louisiana, Maryland, Massachusetts, Mississippi, North Carolina, New Jersey and Pennsylvania

• The training session focused on state discussions of:
  • Common taxpayer entity structures
  • Common transactions that result from such structures
  • Common methods for how MTC personnel or other states have handled audits involving these structures and the resulting transactions
State Emphasis on Transfer Pricing

SITAS Moving Forward

• SITAS will continue to focus on information sharing and training as it seeks to add member states
  • Future SITAS meetings will determine how to generate more state interest in program
• The October SITAS training session included discussions on whether/how to change SITAS’ structure, operations and objectives
• Does new name and broader training agendas signal expansion of Committee’s scope beyond transfer pricing?
Transfer Pricing Issues:
Audit and Litigation
Polling Question No. 4

Has your company prepared or contracted for transfer pricing reports to justify related-party charges for state tax purposes?

A. Never;
B. Once;
C. More than once;
D. Once, with periodic review and updates;
E. Have you seen how much these reports cost?
Recent and Ongoing Litigation

Indiana

- **Rent-A-Center East, Inc. v. Ind. Dep’t of Revenue**, 42 N.E. 3d 1043 (Ind. Tax Ct. 2015)
  - Rejected the DOR’s long-standing position that transfer pricing studies are not relevant to whether a separate return fairly reflects Indiana source income because Indiana’s transfer pricing statute mirrors the language of § 482
  - Held that RAC East did not have to file a combined return with its out-of-state affiliates RAC West and RAC Texas because the record did not show that RAC East engaged in any tax avoidance measures and its intercompany transactions were at arm’s length rates as determined by an independent transfer pricing study

- **Columbia Sportswear USA Corp., v. Ind. Dep’t of Revenue**, 45 N.E.3d 888 (Ind. Tax Ct. 2015)
  - Concluded that because Columbia’s transfer pricing studies demonstrated that its intercompany transactions were conducted at arm’s length rates, its Indiana income was fairly reflected for purposes of Indiana’s transfer pricing statute
Recent and Ongoing Litigation

Indiana (cont’d)

• Ind. Dep’t of Revenue, Ltr. of Findings No. 02-20150171 (Aug. 31, 2016)
  • DOR equalized the operating margin between a retail entity that filed in Indiana (1-2%) and an out-of-state retail services entity (9-12%) to allocate additional income to IN taxpayer
  • The Department acquiesced to the Tax Court’s position regarding the relevancy of transfer pricing studies discussed in RAC and Columbia.
    • “... the Department agrees that the audit cannot set aside Taxpayer’s transfer pricing study on the grounds cited when it required Taxpayer to reapportion the gross operating margin between itself and Retail Services.”
Recent and Ongoing Litigation

District of Columbia

  • Controversial methodology relied upon by several states to assess corporate taxpayers for transfer pricing violations ruled invalid by ALJ
  • OTR and Chainbridge argued that they could aggregate all of Microsoft’s transactions because “Microsoft has engaged in thousands of controlled transactions with over 100 affiliated businesses”—basically arguing that it was too difficult to follow the regulations.
  • OAH found “the fact that Microsoft has 100 or even 2,000 affiliates does not address the question of why there was no effort to isolate the controlled transactions.” The Judge noted that this aggregation of all intercompany transactions is a “significant error” because the relevant profit level ratio may be quite different for different types of transactions.
Recent and Ongoing Litigation

District of Columbia (cont’d)

• *Exxon Mobil, Hess Corp., and Shell Oil*

  OTR continued to utilize the Chainbridge method against Exxon Mobil, Hess, and Shell Oil.
  • The taxpayers argued that after the OAH’s decision in *Microsoft*, the OTR should be estopped from relying on the Chainbridge method.
  • The OAH agreed and held that OTR is estopped from “proceeding to relitigate whether the current Chainbridge methodology can be utilized to assess franchise taxes.”

• On appeal, the D.C. Court of Appeals held that the OAH abused its discretion by not determining whether “exceptional circumstances” existed and if “the interests of justice clearly required” the application of offensive non-mutual collateral estoppel to prevent OTR from using the Chainbridge method debunked in *Microsoft*. **141 A. 3d 1088 (D.C. Ct. App. 2016)**.
  • The D.C. Court of Appeals did not address the validity of the Chainbridge transfer pricing method.
Recent and Ongoing Litigation

District of Columbia (cont’d)

• *Exxon Mobil, Hess Corp. and Shell Oil*
  
The case was remanded to the OAH to determine whether collateral estoppel prohibited OTR from relitigating the issue.

• In March 2017, the OAH rejected arguments by the taxpayers that “exceptional circumstances” exist in their cases for asserting non-mutual collateral estoppel against the OTR.

• The case remains before the OAH to determine whether the Chainbridge method applied the “comparable profits method” in accordance with the IRC § 482 regulations.

• OTR recently hired Ednaldo Silva (founder of RoyaltyStat), one of the drafters of the IRC § 482 regulations, as an independent expert to try to support its use of the Chainbridge method.
Recent and Ongoing Litigation

Utah

• See’s Candies, Inc. v. Auditing Div. of Utah State Tax Comm’n, No. 140401556 (Utah Dist. Ct. 2016)
  
  • The court held that the Utah State Tax Commission abused its discretion by denying the taxpayer a deduction for royalty expenses paid to a related party when the transaction amount was supported by a transfer pricing study;
  
  • The court found that the Commission's authority to reallocate income was limited by the regulations under IRC § 482 because the state law is virtually identical and there is nothing in the statutory scheme to indicate that guidance comes from anywhere other than the 482 regulations.
  
  • Appeal pending at Utah Supreme Court.
Recent Audit Experience: Takedown or Shakedown?

MTC Audit
• Stock question included in multi-state IDRs

Rhode Island
• Department sends letter identifying its anticipated amount of liability for the taxpayer and requests a settlement proposal.
• If no response, Department sends follow-up detailing 100+ pages of “assumptions” the Department has made regarding the taxpayer and specifies that if the taxpayer does not respond, the assumptions will be “presumed correct.”

Connecticut
• Similar to Rhode Island Above

New Jersey
• Michelle Bartolomei – Head of Corporate Audit
  • Transfer pricing issues are “seen frequently at audit.” - TEI Philadelphia Chapter Meeting, September 2017

Pennsylvania
• Use of addback to combat intercompany transactions perceived to be distortive
What’s Next?
Amazon.com v. Commissioner of Revenue, 148 T.C. No. 8 (2017) Will it Have a Chilling Effect?

- Issue was Proper “Exit Tax” Owed on Transfer of Intangible Property (Business Methods, Software Codes, Trademarks) to Luxembourg Subsidiary
  - Each Party hired a dozen experts on valuation of Amazon’s IP;
  - District Court in 205 page decision largely ruled in favor of Amazon; rejected Commissioner’s attempt to argue that effect of IP transfer was to transfer Amazon’s entire goodwill value to European subsidiary.
  - Can the states match the Federal Government’s resources?
So What’s Next?

Outlook of State Transfer Pricing

• Will states efforts rely on contingency auditors?
• Will states follow through with developing resources dedicated to transfer pricing?
• Will interest in transfer pricing be displaced by other state tax solutions (e.g. tax haven legislation; add-back legislation; worldwide combination)?
• Will SITAS move states away from transfer pricing disputes and focus more on economic substance/sham transaction doctrines, deduction denial, forced combination or other discretionary methods to assess taxpayers?
• How will BEPS/international transfer pricing initiatives impact state treatment of intercompany transactions?
• To what extent will states’ efforts be enhanced by information sharing?
• The only certainty is that states will continue to examine intercompany transactions with increasing scrutiny.
How to Prepare

Pre-Audit Steps

• Review intercompany agreements and course of conduct to accurately identify and isolate intercompany transactions
  • This can be time consuming
  • Documentation is key
• Determine the relative functions performed, risks assumed and assets employed by the respective related taxpayers
• Select the best method to test the results of the intercompany transactions
• Review comparables to calculate an arm’s length range of results
  • Documenting rejected comparables can be meaningful
• Compare the taxpayers’ actual results to calculated arm’s length range
  • Monitor results, evaluate arrangements at meaningful intervals
Recourse Against Adjustments

• Under what legal authority is the DOR proposing an adjustment?
  • § 482-like statute?; Add-back statute?; Alternative Apportionment Authority (UDITPA Section 18); Discretionary adjustment authority? i.e., forced combination, alternative apportionment.

• DORs are using their state’s § 482-like provision as a statutory basis for assessment with more frequency, as alternative apportionment may be limited:
  • Burden of proof is on taxpayer, not the party seeking alternative apportionment. See, e.g., Carmax Auto Superstores West Coast, Inc. v. South Carolina Dep’t of Revenue, 411 S.C. 79, 767 S.E.2d 195 (S.C. 2014);
  • Alternative apportionment cannot be used to adjust the tax base;
  • Alternative apportionment may require showing of unusual circumstances.
How to Prepare

• Is the state’s statute identical to, similar to, or directly reference I.R.C. § 482?
  • If not, what is the standard for an adjustment or assessment?
  • “Arm’s Length Price?”
  • “Fair Profits?”
  • Clear Reflection of Income?

• If the statute permits a DOR to act, what types of adjustment does the statute permit?
  • Can DOR use a § 482-like statute to add-back a deduction or force combination when other statutory provisions already provide for those remedies?
  • Indiana: State can use forced combination only upon a showing that other remedies would be inadequate. See Ind. Code § 6-3-2-2(p)-(q);
Questions?

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